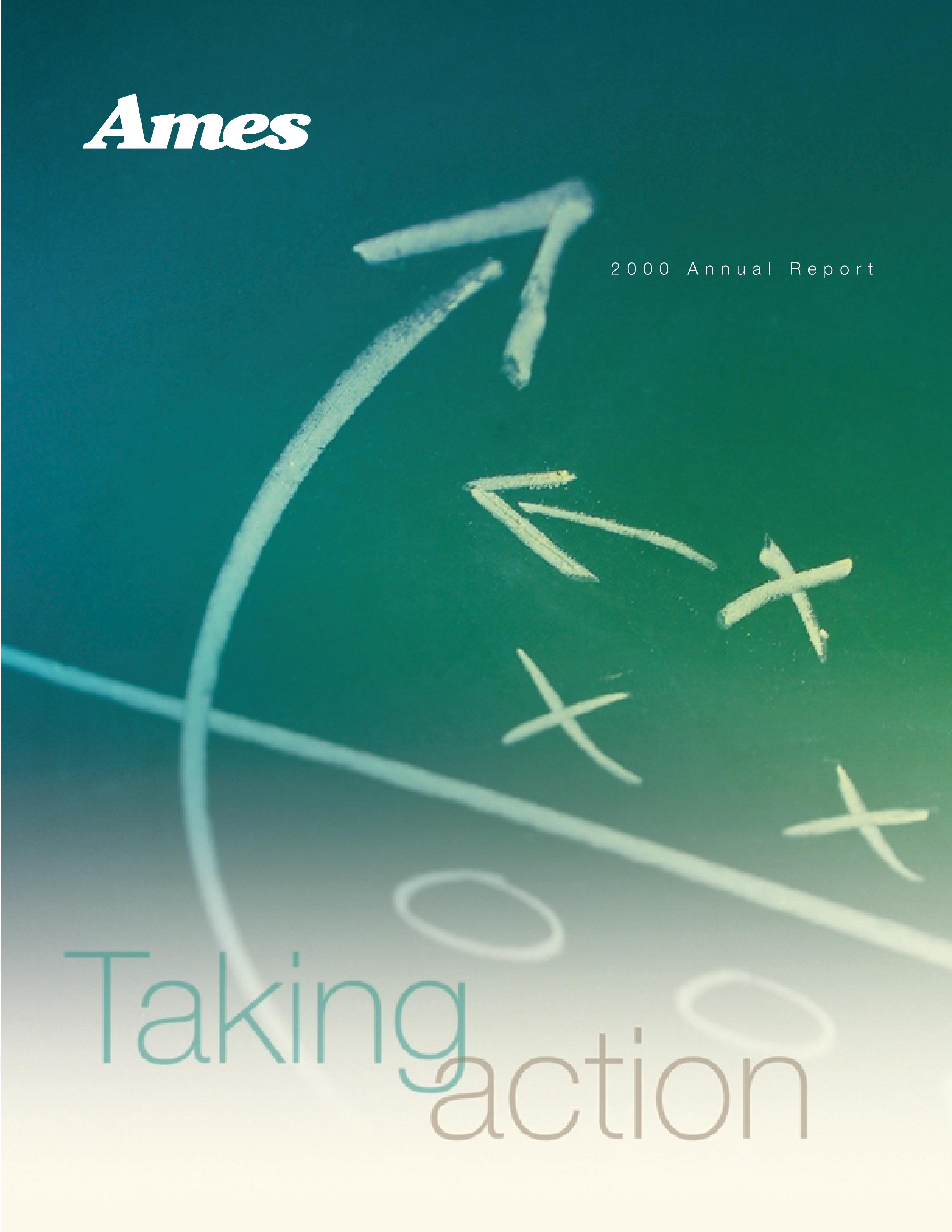

Ames

2000 Annual Report

Taking action

Company profile

Ames Department Stores, Inc., the nation's largest regional discount retailer, excels at satisfying value-driven customers by providing quality, name-brand merchandise, low prices, friendly service and shopping convenience.

Ames is a full-line discount retailer with a broad range of merchandise categories, including family apparel, housewares, domestics, electronics, ready-to-assemble and patio furniture, jewelry, crafts, pet supplies, health and beauty care items, stationery, sporting goods, toys, seasonal products and more.

"Faced with many

challenges in 2000,

our management team

responded by creating

long-term solutions,

not short-term fixes."

Strategic vision

Joseph R. Ettore

To our shareholders

Denis T. Lemire
President and Chief Operating Officer

Joseph R. Ettore
Chairman and Chief Executive Officer

Rolando de Aguiar
Senior Executive Vice President

When the retail world faces as challenging a year as we had in 2000, it's not enough to simply weather the storm and hope for the best. You need to tackle the situation head-on.

As difficult a year for retail as 2000 turned out to be, we were not distracted. We realized it would be a difficult year. We developed a plan and a strategy which we executed.

We had many issues to deal with in 2000, most of which were beyond our control. Bad weather – always difficult for retailers – followed us throughout the spring and summer months. Oil and other energy prices soared. Interest rates started edging up. The impact of these factors on the retail industry was to discourage shoppers and reduce spendable income. Our customers, in particular, were very much affected by these events.

We relied on our strategy which has allowed us to co-exist and even thrive among much larger discount retailers located in our backyard. How did we do it? We know who our customer is. We do not try to be all things to all people. Our focus is on reliable products at affordable prices. We design our stores with our particular customer in mind.

And we relied on our game plan. We planned to open 26 new Ames stores during 2000 and we did just that. Among those new stores were ten located in the Chicago area, a brand new territory for us, and five of those were former Goldblatt's stores. We converted these stores to the proven Ames format.

There were other challenges along the way that we could and did respond to quickly. When we learned that our popular 55 Gold® senior Tuesday discount program was not catching on in our new stores as quickly as we expected in some areas, we intensified our marketing efforts. Throughout the chain, Tuesdays are now the first or second busiest day of the week.

When consumer confidence began to wane, we saw the writing on the wall early enough to reduce our inventories. Our quick response greatly reduced our inventory exposure and markdown liability in future periods.

55

Our 55 Gold® Club is a popular program with customers.

100

We set in place a plan to reduce capital expenditures by $100 million in 2001.

26

We planned to open 26 new Ames stores during 2000 and we did just that.

800

Our $800 million senior financing agreement will give Ames availability and flexibility.

We never rely on a cookie-cutter approach to our business. That includes our marketing efforts. In markets where the Sunday newspaper is not widely read by our customers, we reached out to them through a combination of radio and TV advertising. We have seen improvement in our sales. We are always ready to try something new and look for innovative solutions.

While 2000 was a year of many challenges, we also had some great successes. Our entry into the Chicago market was very well received. As many of the larger, national chains are leaving urban areas for the suburbs and the malls, we are locating our stores in our customers' neighborhoods. Our smaller store size and customer focus are a perfect fit for these communities.

Late in the year 2000 we announced several initiatives to address the slow economic pace we faced and made the decision to close 32 stores, all but one of which had come to us through the Hills acquisition. This was a difficult decision. In a better economic climate, we could have given these stores more time to improve sales, but we didn't have the time in this economic environment.

In addition, we set in place a plan to reduce 2001 operating expenses by $28 million and 2001 capital expenditures by nearly $100 million. Everything not directly providing service to our customers was up for review. Overall – every line item in the budget was reviewed and needed strong justification in order to remain in the budget for 2001.

We also relied on our strong logistics network to keep inventories at optimum operating levels. Our objective is always to keep inventories balanced while reducing them throughout our system.

In addition to these initiatives, we have a new $800 million senior secured financing agreement for which GE Capital is acting as agent. This will give the Company improved availability and increased financial flexibility in the future.

Faced with many challenges in 2000, our management team responded by creating long-term solutions, not short-term fixes. As a result, your Company will be leaner and stronger in the future.

Sincerely,

Joseph R. Ettore
Chairman and Chief Executive Officer

Conversation with management

These are tough economic times for retailers. How is Ames managing through this difficult period?

Joe Ettore

We are truly a team here at Ames. That is both our culture and our management style. And, we work as a team to control everything that is controllable.

We operate with efficiency and flexibility. Our state-of-the-art systems permit us to increase or decrease the flow of inventory to our stores according to demand. This results in fewer markdowns during economic slowdowns, but still allows us to respond quickly to an increase in demand.

We do not try to be all things to all people. We have two major categories of customers: women between the ages of 18 and 55 with a family income of $25,000 to $40,000 – often it takes two people working to earn that amount – and, men and women over the age of 55. We focus our attention on what works with our value-driven customer.

What does Ames do differently than other discount retailers?

Joe Ettore

To compete in today's retail environment you have to stand out from the crowd, or you'll get lost in the crowd. We stand out in several ways:

Our customers lead busy lives. Our stores are smaller in size than other discount retailers making ours easy to navigate. Our average store size is about 60,000 selling square feet. Other discount retailers' stores are often two or three times our size.

We also have a unique "racetrack" floor plan store design. Customers can make one circle of our store and pass by every department in the process. They don't have to go up and down endless aisles or face a maze with no exits. Our merchandise is not piled high to the rafters – it is within easy reach. We have extra wide aisles and clear signage, making our stores easy to navigate.

While our merchandise categories are similar to other full-line discounters, we have some special niches. We have a large assortment of patio items – more than most other discount retailers. We also are very committed to crafts and have a complete array of selections for our customers who do a lot of their own crafts, knitting and sewing to help make ends meet. Our ready-to-assemble furniture is very popular and a destination area for shoppers.

We have the 55 Gold® Club for our customers aged 55 and over. Every Tuesday we offer a 10 percent discount to club members on all merchandise – including sale items. This program has helped to make Tuesdays the first or second busiest sales day of the week at Ames.

What did you do to control operating costs in 2000?

Rolando de Aguiar

Inventory control was an important issue. Using our logistics network, by year-end 2000 our inventories were 13 percent lower per store than in the prior year. This inventory reduction, particularly in seasonal clothing, greatly reduced our markdown risk.

In addition, during the year we reduced overhead costs by over $40 million by taking advantage of new advances in technology and examining every aspect of our operations to reduce expenses.

Denis Lemire

We directed our efforts to areas where we would get the biggest return on investment. We trimmed expenses at the store level by condensing our number of regional offices from six to four. We looked at everything – any expense not directly related to satisfying our customer got a very close review. We instituted in-house campaigns to save and no expense was too small to be reviewed.

Joe Ettore

We took a hard look at our store operations and decided to close 31 under-performing former Hills stores. These stores were performing marginally at the time of the acquisition, but we wanted to give them the opportunity to make a go of it. In many of them, we had invested minimal capital for renovations. In better economic times they may have been successful, but we had to make the tough decision last fall to close those stores.

Going forward in 2001 and beyond, how do you plan to bolster profitability and reduce expenses?

Joe Ettore

Our state-of-the-art POS system has given us a wealth of sales information. We're analyzing that data to fine-tune our pricing structure and maximize profitability as well as to offer our customers the greatest value for their hard-earned money.

Rolando de Aguiar

We run a very lean organization and this keeps us competitive. Our advanced systems allow us to have the right merchandise selections at the store at the time the customer needs it.

Denis Lemire

Also, our merchandising expertise gives us a competitive edge. We are positioned to take advantage of bargains in the marketplace and get them on the shelves at our stores faster than our competitors. We are also looking at various targeted marketing and pricing initiatives to maintain profitability.

Do you have plans to grow your business in 2001?

Joe Ettore

Because of the current economic climate, we have been cautious and have limited our plans for growth in 2001. However, we did open five new stores in March 2001. And, with the shakeout in the retail environment that took place in 2000, it is possible that properties that fit our format may become available. We will certainly look at each situation and evaluate it in light of the economic environment at that time.

What makes Ames a good investment?

Joe Ettore

We have a seasoned management team in place. We have demonstrated that we can manage our inventories, reducing our exposure to markdowns. We have demonstrated that we can adapt quickly to changing circumstances. We have adapted to the current economic environment. We have a proven formula for our stores and a loyal customer base.

We will grow and prosper as the economy strengthens and our customers regain confidence.

Directors Officers

Board of Directors

Joseph R. Ettore ✶
Chairman of the Board and Chief Executive Officer

Francis X. Basile ■ ●
Retired Chairman and Chief Executive Officer, CIT Group/Factoring, Inc.

Paul M. Buxbaum ■ ♦ ✶
President, Buxbaum Group & Associates, Inc.

Alan Cohen ♦ ✶
Chairman, Alco Capital Group LLC

Richard M. Felner ■ ●
Richard M. Felner Associates

Sidney S. Pearlman ♦ ●
Retired Senior Vice President General Merchandise Manager, Younkers, Inc.

Joseph A. Pollicino ■ ♦
Retired Vice Chairman CIT Group

■ Audit Committee
Paul Buxbaum, Chairman

♦ Compensation Committee
Alan Cohen, Chairman

✶ Executive Committee
Paul Buxbaum, Chairman

● Governance Committee
Richard Felner, Chairman

Corporate Officers

Joseph R. Ettore
Chairman of the Board and Chief Executive Officer

Denis T. Lemire
President and Chief Operating Officer

Rolando de Aguiar
Senior Executive Vice President, Chief Financial and Administrative Officer Ames Department Stores, Inc. and President, AmesPlace.com

Grant C. Sanborn
Executive Vice President, Operations

Lisa M. Bachmann
Senior Vice President, Allocation & Planning

Eugene E. Bankers
Senior Vice President, Marketing

Catherine A. Berey
Senior Vice President, Human Resources

David S. Covitz
Senior Vice President, General Merchandise Manager, Hardlines

David H. Lissy
Senior Vice President, General Counsel & Corporate Secretary

Alfred B. Petrillo, Jr.
Senior Vice President, Store Planning

Sanford H. Sansavera
Senior Vice President, General Merchandise Manager, Softlines

John Tempesta
Senior Vice President, Logistics

James A. Varhol
Senior Vice President, Asset Protection

Linda M. Cote
Vice President, Planning and Treasury

William D. Hess
Regional Vice President, Stores

Gary E. Huber
Regional Vice President, Stores

Beth Ann Keegan
Vice President, Advertising

Richard J. Marsan, Jr.
Vice President, Store Planning/ Merchandise Presentation

Richard K. McDonald
Vice President, Store Operations

Nick Nuccetelli, Jr.
Regional Vice President, Stores

John J. Perry, Jr.
Vice President, Systems Development

James J. Pirretti
Vice President, Legal

Joseph J. Staffieri
Vice President, Human Resources

Michael A. Torti, Jr.
Regional Vice President, Stores

Mark von Mayrhauser
Vice President, Controller

Norman R. Veit, Jr.
Vice President, Technology Services

Report of Management to the Stockholders

The management of Ames is responsible for the integrity and objectivity of the financial and operating information contained in this report, including the consolidated financial statements covered by the Report of Independent Public Accountants. These statements were prepared in conformity with generally accepted accounting principles and include amounts that are based on the best estimates and judgments of management.

The Company has a system of internal accounting controls that provides management with a reasonable assurance that transactions are recorded and executed in accordance with its authorizations, that assets are properly safeguarded and accounted for, and that financial records are maintained so as to permit preparation of financial statements in accordance with generally accepted accounting principles. This system includes written policies and procedures, an organizational structure that segregates duties, and a comprehensive program of periodic audits by the internal auditors. The Company also has instituted policies and guidelines that require employees to maintain the highest level of ethical standards.

In addition, the Audit Committee of the Board of Directors, consisting solely of outside directors, meets periodically with management, the internal auditors and the independent public accountants to review internal accounting controls, audit results and accounting principles and practices, and annually recommends to the Board of Directors the selection of independent public accountants.

Joseph R. Ettore
Chairman and Chief Executive Officer

Rolando de Aguiar
Senior Executive Vice President and Chief Financial Officer

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Management's Discussion and Analysis of Financial Condition and Results of Operations.

The Ames fiscal year ends on the Saturday nearest January 31st. Our fiscal years ended January 29, 2000 and January 30, 1999, which we refer to as "Fiscal 1999" and "Fiscal 1998," respectively, consisted of fifty-two weeks. Our fiscal year ended February 3, 2001, which we refer to as "Fiscal 2000," consisted of fifty-three weeks.

The following discussion and analysis should be read in conjunction with the consolidated financial statements and related notes appearing elsewhere in this annual report.

Results of Operations
Fiscal 2000 Compared to Fiscal 1999

The following table illustrates the consolidated results of operations for the fifty-three weeks ended February 3, 2001, as compared to the consolidated results of operations for the fifty-two weeks ended January 29, 2000.

(In millions)	Fiscal 2000	Fiscal 1999	Percentage Change
Total net sales	**$3,953.6**	$3,836.8	3.0%
Leased department and other income	**46.4**	41.7	11.3%
Total revenue	**4,000.0**	3,878.5	3.1%
Costs and expenses:			
Cost of merchandise sold	**2,932.2**	2,715.4	8.0%
Selling, general, and administrative expense	**1,058.7**	1,068.2	(1.0)%
Depreciation and amortization expense, net	**79.7**	65.5	21.7%
Interest and debt expense, net	**88.0**	60.8	44.7%
Store closing charge	**129.8**	—	100%
Loss before income taxes	**(288.4)**	(31.4)	
Income tax benefit	**54.8**	49.6	
(Loss) income before cumulative effect adjustment	**(233.6)**	18.2	
Cumulative effect adjustment, net of tax	**—**	(1.1)	
(Loss) income before extraordinary item	**(233.6)**	17.1	
Extraordinary item, net of tax	**(7.0)**	—	
Net (loss) income	**$ (240.6)**	$ 17.1	

The consolidated results of operations for Fiscal 1999 include the results of the former Hills stores during the period they were operated by professional liquidators under an agency agreement (see detailed discussion below under "Fiscal 1999 Compared to Fiscal 1998").

During Fiscal 2000, beginning in early spring, our business was affected by a number of economic conditions. With higher gasoline prices leading the way, our customers' disposable income levels were reduced, affecting their purchasing power. This, coupled with a cold and wet spring, resulted in lower than forecast sales. A cool summer, continued high gasoline prices, and an economic slowdown later in the year further affected our sales.

As the economy continued to slow in the third quarter, we reacted decisively with a focus on reducing inventories for the fall and Holiday season, curtailing selling, general, and administrative expenses, limiting capital expenditures, and reviewing our store base to ensure that we closed all stores whose closure would result in a net cash flow improvement.

The increases in net sales and leased department and other income in Fiscal 2000 compared to Fiscal 1999 are primarily attributable to the net addition of twenty-four new stores during the year, partially offset by a 2.1% decrease in same store sales.

Gross margin decreased $100.0 million in Fiscal 2000 compared to Fiscal 1999. Gross margin as a percentage of sales decreased from 29.2% in Fiscal 1999 to 25.8% in Fiscal 2000. The decrease is primarily attributable to higher markdowns and a reduction in the vendor allowances received in Fiscal 2000 when compared to Fiscal 1999 when we opened 163 new stores. We incurred higher markdowns in 2000 than in 1999 resulting from significantly higher seasonal clearance activities in the first half of 2000.

The decrease in selling, general, and administrative expenses during Fiscal 2000 compared to Fiscal 1999 was primarily a result of a decrease in pre-opening expenses partially offset by a full year of operating expenses in the converted former Hills stores. Selling, general, and administrative expenses decreased as a percentage of sales from 27.8% in Fiscal 1999 to 26.8% in Fiscal 2000.

The increase in depreciation and amortization expense during Fiscal 2000 compared to Fiscal 1999 resulted primarily from a full year's depreciation and amortization of the fixed assets and beneficial lease rights acquired from Hills in Fiscal 2000 compared to less than a full year's depreciation and amortization in Fiscal 1999.

The increase in interest expense in Fiscal 2000 is mainly attributable to a higher level of borrowings under our revolving credit facility as well as a full year of interest expense associated with the Ames Senior Notes issued in April 1999.

The $129.8 million store closing charge is related to the store closings described below. We recorded an extraordinary charge of $7.0 million in Fiscal 2000 for the write-off of deferred financing costs and other exit expenses associated with the early termination of our prior revolving credit facility.

We recorded a consolidated income tax benefit of $54.8 million in Fiscal 2000 compared to $49.6 million in Fiscal 1999. The increase is primarily a result of our Fiscal 2000 operating loss partially offset by an increase in the valuation allowance recorded against certain deferred tax assets. See Note 8 to the consolidated financial statements for additional information.

Store Closing Charges

On November 9, 2000, we announced the planned closing of thirty-two stores. All but one of the stores were under-performing stores that we acquired in the Hills acquisition in December 1998. The other store was closed as a result of the expiration of its lease. In connection with the closings, we recorded charges of $139.3 million, including a $9.5 million charge for the impairment of inventory classified as part of cost of merchandise sold. The stores were closed during the first quarter of 2001.

The following items represent the major components of the total charges recorded in connection with the store closings:

Item *(in thousands)*	Charge
Lease costs	$ 88,815
Net fixed asset write-down	29,307
Other occupancy costs	9,101
Severance costs	2,583
Store closing charge	129,806
Inventory write-down	9,453
Total charges	$139,259

The lease and other occupancy costs provided for in the store closing charge include all projected occupancy costs from date of closing until estimated lease disposition date.

Fixed assets associated with the closing stores were reviewed to determine whether their recorded values had been diminished. The review of the closed stores resulted in a write-down of $29.3 million which includes $19.7 million related to fixtures, equipment, and leasehold improvements, and $9.6 million related to beneficial lease rights.

During Fiscal 2000 and Fiscal 1999, with respect to the thirty-two stores, we recorded net sales of $205.0 million and $147.7 million, respectively, exclusive of the period when the thirty-one former Hills stores were operating under the "Hills" name. For the same years, the pre-tax operating loss for the thirty-two stores was $20.4 million and $12.9 million, respectively.

We expect to incur substantially all of the charges included in the reserve except the lease and other occupancy costs in the first quarter of the fiscal year ending February 2, 2002. Lease and other related occupancy costs are expected to be paid over the terms of the leases. We expect to fund these costs with cash from operations. We believe closing these under-performing stores will improve profitability.

Fiscal 1999 Compared to Fiscal 1998

On December 31, 1998, we acquired approximately 81.3% of the outstanding voting stock of Hills Stores Company. Accordingly, the operations of Hills and its subsidiaries during the month of January 1999 are included in our consolidated results of operations for Fiscal 1998.

During Fiscal 1999, the inventory in the 155 former Hills stores was liquidated, and 151 stores were remodeled and opened as Ames stores. This process was completed in September 1999. During the liquidation period, professional liquidators operated the former Hills stores under an agency agreement with Ames. Ames received a minimum guaranteed amount of 40% of the initial ticketed retail price of the inventory sold and had the potential to receive a greater return if the sale proceeds exceeded a specified percentage of retail value. For financial reporting purposes in the charts that follow, Hills net sales represent the actual sale proceeds from the merchandise liquidation sales, its cost of merchandise sold represents the cost of merchandise sold as adjusted for the guaranteed return amount, and its selling, general, and administrative expenses include the portion of those proceeds that were to be paid to the liquidators.

Upon completion of the liquidation and remodeling, the Hills stores were reopened and participated in grand opening promotions. Consequently, we incurred higher than normal pre-opening and promotion expenses in Fiscal 1999.

Because of the liquidation activity, the remodeling activity, and the large volume of grand openings with their associated expenses, the consolidated operating results are not representative of those of a retailer operating in the ordinary course of business and are not directly comparable to previously published Ames results exclusive of Hills.

	Fiscal 1998	Fiscal 1999				
(In millions)	Ames	Ames	Hills	Other	Layaway Adjustment	Total
Total net sales	$2,386.5	$3,465.6	$375.6	$ —	$(4.4)	$3,836.8
Leased department and other income	29.2	39.1	2.6	—	—	41.7
Total revenue	2,415.7	3,504.7	378.2	—	(4.4)	3,878.5
Costs and expenses:						
Cost of merchandise sold	1,711.3	2,467.8	251.2	—	(3.6)	2,715.4
Selling, general, and administrative expense	606.9	838.7	153.0	76.5	—	1,068.2
Depreciation and amortization expense, net	11.3	49.1	11.1	5.3	—	65.5
Interest and debt expense, net	11.4	54.1	4.1	2.6	—	60.8
Income (loss) before income taxes	74.8	95.0	(41.2)	(84.4)	(0.8)	(31.4)
Income tax (provision) benefit	(26.7)	(34.2)	14.8	68.7	0.3	49.6
Income (loss) before cumulative effect adj.	48.1	60.8	(26.4)	(15.7)	(0.5)	18.2
Cumulative effect adjustment, net of tax	—	—	—	—	(1.1)	(1.1)
Net income (loss)	$ 48.1	$ 60.8	$ (26.4)	$(15.7)	$(1.6)	$ 17.1

The "Ames" column for Fiscal 1998 represents the results of the Ames store base excluding (a) the results of operations for the Hills stores acquired as of December 31, 1998 and (b) other costs and charges related to the Hills acquisition. Including the effect of the Hills stores and other costs related to the acquisition, we recorded consolidated net income of $33.8 million for the fifty-two weeks ended January 30, 1999.

The "Ames" column for Fiscal 1999 represents (a) the results of the Ames store base, (b) the results of the former Hills stores after their conversion to Ames stores and (c) certain expenses associated with the acquisition of Hills, including the interest expense on the acquired Hills senior notes and a pro rata share of the amortization of the goodwill recorded in connection with the acquisition.

The "Hills" column for Fiscal 1999 represents (a) the results of operations for the Hills stores during the period that these stores were operated pursuant to an agency agreement, including depreciation and interest expense directly associated with such stores and (b) Hills corporate overhead expenses, principally the Canton, Massachusetts's corporate facility (see Note 2 to the accompanying consolidated financial statements for further discussion of the agency agreement accounting).

The "Other" column for Fiscal 1999 represents expenses incurred during the period of remodeling the Hills stores (i.e., pre-opening expenses incurred during the conversion or "dark" period) as well as certain other expenses and tax benefits.

The "Layaway Adj." column represents the impact of the change in the method of accounting for layaway sales. We adopted the change in accounting for layaway sales in the fourth quarter of Fiscal 1999 in consideration of Staff Accounting Bulletin No. 101 "Revenue Recognition" issued by the staff of the Securities and Exchange Commission in December 1999.

The liquidation and remodeling activity in the former Hills stores distorts any direct comparison of the principal components of Ames consolidated results for Fiscal 1999 and Fiscal 1998 and prior years. Accordingly, in the discussion that follows, Ames net sales, gross margin, selling, general, and administrative expenses, and its leased department and other income for Fiscal 1999 and Fiscal 1998 will be compared excluding the pre-conversion Hills results and other charges. The comparison of depreciation and amortization expense as well as interest and debt expense will be on a consolidated basis.

The $1.1 billion increase in net sales in Fiscal 1999 was due primarily to the sales contribution of the former Hills stores after conversion to the Ames format and 6.2% growth in same store sales. We experienced strong increases in our Ladies Sportswear, Toys and Home Entertainment departments.

A substantial portion of the $9.9 million increase in leased department and other income in Fiscal 1999 resulted from additional leased sales originating in the former Hills stores, as well as an increase in layaway fees, also originating in the former Hills stores.

Gross margin increased $322.6 million in Fiscal 1999 compared to Fiscal 1998. The increase is primarily attributable to the inclusion of the former Hills stores and an increase in the gross margin rate from 28.3% to 28.8% in Fiscal 1999. The gross margin rate in Fiscal 1999 benefited from lower markdowns.

The $231.8 million increase in selling, general, and administrative expenses in Fiscal 1999 was primarily a result of the addition of the former Hills stores. Selling, general, and administrative expenses decreased as a percentage of net sales from 25.4% in Fiscal 1998 to 24.2% in Fiscal 1999. The decrease resulted from the 6.2% comparable store sales gain and improved efficiencies of scale due to the Hills acquisition.

Depreciation and amortization expense increased $51.0 million in Fiscal 1999 compared to Fiscal 1998. The increase resulted from additional depreciation and amortization of the former Hills fixed assets and beneficial lease rights and the amortization of goodwill. The beneficial lease rights and goodwill related to the Hills acquisition are being amortized on a straight-line basis over the term of the underlying lease (twenty-five years on average) for the lease rights and twenty-five years for goodwill. The amortization of the excess of our revalued net assets over equity under fresh start reporting remained the same in Fiscal 1999 as in Fiscal 1998. We are amortizing this amount over a ten-year period, which will conclude in January 2003.

Net interest expense increased $45.6 million in Fiscal 1999 compared to Fiscal 1998. The increase was primarily attributable to interest expense incurred for our 10% senior notes, the Hills capital lease and financing obligations, and a higher level of borrowings under our bank credit agreement. During Fiscal 1999, we completed the issuance of our 10% senior notes to support the conversion of the former Hills stores. See the liquidity and capital resources section of this document for further discussion of these events.

We recorded a consolidated income tax benefit of $49.6 million in Fiscal 1999 compared to an $18.8 million provision in Fiscal 1998. The Fiscal 1999 benefit primarily represents the reduction of a valuation allowance of $38.1 million previously recorded against certain deferred tax assets, which reflected our expectation of using the net operating loss carry-forwards and other deferred tax assets in the foreseeable future.

Liquidity and Capital Resources

Our principal sources of liquidity are our credit agreement, cash from operations, and cash on hand. Our current credit agreement, which expires March 2, 2004, provides for a credit facility of up to $800 million. Borrowings under the agreement are secured by substantially all of our assets and we are required to meet certain financial covenants if our availability under the credit agreement falls below specified levels. Our peak borrowing level in Fiscal 2000 under our previous bank credit agreement was $611.1 million.

On April 27, 1999, we completed the sale of $200 million of Ames 10% senior notes. The net proceeds from the sale of the Ames senior notes, approximately $193.4 million, were used to reduce outstanding borrowings under our bank credit facility. The Ames senior notes pay interest semi-annually in April and October and mature in April 2006.

On May 24, 1999, we completed the public offering of 5.1 million shares of Common Stock at a price of $38.75 per share. The proceeds of approximately $187.3 million, net of underwriting discounts, were used to reduce our borrowings under the bank credit facility and for general corporate purposes.

Our cash position increased $19.1 million during Fiscal 2000. The increase was due primarily to $187.3 million in additional credit

agreement borrowings partially offset by $127.1 million of capital expenditures, a reduction in accrued expenses of $18.9 million, and debt repayments of $22.7 million. Our cash position decreased $5.1 million during Fiscal 1999. The decrease was due primarily to $209.6 million of capital expenditures, inventory investments of $181.5 million, and $25.8 million in debt and capital lease payments, partially offset by $129.6 million of borrowings under our bank credit agreement, $193.4 million from the issuance of the Ames senior notes, and $187.3 million from the issuance of Common Stock.

The $87.3 million decrease in merchandise inventories in Fiscal 2000 resulted from our efforts to minimize inventories in the wake of the economic slowdown. Merchandise inventories increased $210.1 million in Fiscal 1999 due to the addition of twelve new stores, in addition to fully stocking the former Hills stores and recording the inventory in the converted Hills stores at cost in Fiscal 1999 as compared to liquidation value in Fiscal 1998.

Net fixed assets increased by $46.2 million during Fiscal 2000 due to $127.1 million in capital expenditures partially offset by $84.7 million in depreciation expense. Net fixed assets increased by $130.1 million during Fiscal 1999 due to $209.6 million in capital expenditures, primarily relating to remodeling the former Hills stores, and opening twelve other stores. These additions were partially offset by the additional writedown of $29.8 million in fixed assets acquired from Hills and depreciation expense of $61.1 million recorded during Fiscal 1999.

Beneficial lease rights represent the excess of the fair market value of the acquired Hills leases over contract value of those leases. We are amortizing this amount over the terms of the related leases using the straight-line method.

The $2.6 million reduction in goodwill in Fiscal 2000 is entirely from amortization. Goodwill decreased $169.4 million in Fiscal 1999 as a result of the final determination of the fair market value of the assets and liabilities acquired with the Hills stores and a full year of amortization expense, which approximated $8.3 million. The primary changes were the reduction of $114.1 million deferred tax asset valuation allowance, a reduction in accrued liabilities and reserves of $48.3 million as these liabilities were no longer deemed to be required, and the increase of $28.3 million in inventory values. When the Hills inventory was liquidated, proceeds generated were greater than anticipated. These changes were partially offset by an additional $29.8 million write-down of fixed assets (primarily fixtures) acquired from Hills to recognize their deemed fair value. Goodwill is being amortized over twenty-five years using the straight-line method.

Accounts payable increased $20.8 million in Fiscal 1999 due to an increase in merchandise receipts in January 2000 over January 1999.

Long-term debt as of February 3, 2001 consisted of borrowings under our bank credit agreement of $361.8 million, $44.3 million of Hills senior notes, and $200 million of Ames senior notes.

We believe that the availability under our credit agreement, along with our current available cash plus expected cash flows from our operations, will enable us to fund our expected needs for working capital, capital expenditures, and debt service requirements. Our sales results in the fiscal month of March were negatively impacted by severe weather, as was the case with others in the retail industry, and were well below plan. Achievement of expected cash flows from operations and compliance with our credit agreement covenants (see Note 4 to the consolidated financial statements) are dependent upon a number of factors, including the attainment of sales, gross profit, expense levels, vendor relations, and flow of merchandise that are consistent with our financial projections, particularly for the balance of the Spring season.

Capital lease and financing obligations decreased by $18.1 million during Fiscal 2000 as payments on capital lease obligations exceeded new capital leases.

We have not paid any cash dividends during the past five fiscal years. The payment of cash dividends is restricted under the terms of our credit agreement.

Capital Expenditures

Capital expenditures for Fiscal 2000 were $127.1 million, and primarily consisted of costs related to the opening of twenty-six new stores, remodeling of twenty-three stores, and systems and facility improvements. Capital expenditures for Fiscal 1999 were $209.6 million and included, among other items, the opening of twelve new stores, the remodeling of the former Hills stores, and the upgrading of selected management information systems, including the completion of our chain-wide installation of new point-of-sale information equipment and related software in our stores.

Capital expenditures are expected to be approximately $40.0 million in Fiscal 2001. These capital expenditures will be primarily comprised of five new stores and maintenance of our existing stores. We expect to finance these expenditures through cash flow from operations and borrowings under our credit agreement. Land, buildings and improvements are financed principally through long-term leases.

Seasonality

Our business is seasonal in nature, with a large portion of our net sales occurring in the second half of our fiscal year as a result of the back-to-school and Christmas shopping seasons. Net sales are highest in the last fiscal quarter (34% of our annual net sales in Fiscal 2000). The demand for working capital is heaviest in May and from August through November, when sufficient merchandise must be purchased for the spring, back-to-school, and Christmas seasons, respectively.

Legal

We are party to various claims and legal proceedings on a wide range of matters that arise in the ordinary course of business. Ames intends to defend these issues vigorously and believes that the final outcome of the various proceedings will not have a material adverse impact on its consolidated financial position or results of operations.

New Accounting Matters

In June 1998, the Financial Accounting Standards Board ("FASB") issued Statement of Financial Accounting Standards ("SFAS") No. 133, "Accounting for Derivative instruments and Hedging Activities." In June 2000, the FASB issued SFAS No. 138, "Accounting for Certain Derivative Instruments and Certain Hedging Activities," an amendment of SFAS No. 133. These statements establish accounting and reporting standards requiring that every derivative instrument

(including certain derivative instruments embedded in other contracts) be recorded in the balance sheet as either an asset or liability measured at its fair value. The statements also require that changes in a derivative's fair value be recognized currently in earnings unless specific hedge accounting criteria are met. The statements are effective, prospectively, for all fiscal quarters of all fiscal years beginning after June 15, 2000. We adopted SFAS No. 133, as amended by SFAS No. 138, effective the beginning of Fiscal 2001. The impact of adopting this standard was not significant.

In December 1999 the Securities and Exchange Commission issued Staff Accounting Bulletin ("SAB") No. 101 "Revenue Recognition." Under SAB No. 101, we were required to change the method in which we account for layaway sales. Prior to the adoption of SAB No. 101, we recorded layaway sales when customers placed merchandise on layaway. The pronouncement mandates that layaway sales be recorded when the customer takes possession of the merchandise. We adopted SAB No. 101 during the fourth quarter of Fiscal 1999, effective as of the beginning of Fiscal 1999. The impact of adopting this pronouncement resulted in a cumulative effect adjustment to Fiscal 1999 earnings of approximately $1.1 million, net of $0.6 million tax benefit.

Forward-Looking Statements

The statements contained or incorporated by reference under the captions "Management's Discussion and Analysis of Financial Condition and Results of Operations," "Disclosure about Market Risk" and elsewhere in this annual report that are not historical facts are "forward-looking statements," as that term is defined in the Private Securities Litigation Reform Act of 1995. Those statements include all discussions of strategy as well as statements that contain such forward-looking expressions as "believes," "estimates," "intends," "may," "will," "should," or "anticipates" or the negative thereof. In addition, from time to time, our representatives or we have made or may make forward-looking statements orally or in writing. Furthermore, forward-looking statements may be included in our filings with the Securities and Exchange Commission as well as in the press releases or oral presentations made by or with the approval of one of our authorized executive officers.

We caution you to bear in mind that forward-looking statements, by their very nature, involve assumptions and expectations and are subject to risks and uncertainties. Although we believe that the assumptions and expectations reflected in the forward-looking statements contained herein are reasonable, no assurance can be given that those assumptions or expectations will prove to have been correct. Important factors that could cause actual results to differ materially from our expectations include, but are not limited to, the ones discussed below.

Our financial performance is sensitive to changes in overall economic conditions that impact consumer spending, particularly discretionary spending. Future economic conditions affecting disposable consumer income such as employment levels, business conditions, fuel and energy costs, interest rates, and tax rates could reduce consumer spending or cause consumers to shift their spending to other products. A general slowdown in the United States economy or an uncertain economic outlook would adversely affect consumer spending habits, which would likely result in lower net sales than expected on a quarterly or annual basis. A general reduction in the level of discretionary spending or shifts in consumer discretionary spending to other products could adversely affect our growth, net sales, and profitability. Our operating results may be adversely affected by unfavorable local, regional or national economic conditions, especially those affecting the Northeast, Midwest or Mid-Atlantic Regions where our 452 stores are currently located.

Our business is affected by the pattern of seasonality common to most retailers. Our net sales and net income are generally weakest during the first two fiscal quarters and strongest during the third and fourth quarters. Historically, we have generated a significant portion of our net sales and profits during our fourth fiscal quarter, which includes the Christmas selling season, and have experienced losses or minimal earnings in the first, second, and third fiscal quarters.

We realize a disproportionately large amount of our net sales and net income during the Christmas selling season. In anticipation of the holidays, we purchase substantial amounts of seasonal inventory and hire many temporary employees. If for any reason our net sales during the Christmas selling season were below seasonal norms, we could have excess inventory, necessitating mark-downs to minimize this excess, which would reduce our profitability and adversely affect our operating results.

We continually change our mix of seasonal merchandise, non-seasonal merchandise, and consumable products. Our gross profit margins may fluctuate from quarter to quarter. Our quarterly and annual results of operations, including comparable store net sales and income, also fluctuate for a variety of other reasons, including adverse weather conditions, particularly during the peak Christmas season, and difficulties in obtaining sufficient quantities of merchandise from our suppliers.

The retail industry is highly competitive and we expect competition to increase in the future. We compete with many smaller stores offering a similar range of products. Although Ames is the largest regional discount retailer in the United States, we are still considerably smaller in terms of our total number of stores, sales and earnings than the three leading national chains: Wal-Mart, Kmart, and Target Stores. Each of these chains, as well as other regional operators, currently operates stores within our regional market and competes with us for customers and potential store locations. We anticipate a further increase in competition from these national discount store chains.

Our merchandising focus is primarily directed to consumers who, we believe, are underserved by the major national chains. Although this approach, combined with our smaller store size, has enabled us to compete effectively with these chains and operate profitably in proximity to their stores, we remain vulnerable to the marketing power and high level of consumer recognition of the major national discount chains. We expect to face increased competition in the future which could adversely affect our business, results of operations, and financial condition.

The efficient operation of our business is heavily dependent on our information systems. We depend on others to maintain and periodically upgrade many of these systems so that they can continue to support our business. The software programs supporting many of our systems were licensed to us by independent software developers. The inability of these developers to continue to maintain and upgrade these information systems and software programs would disrupt our operations if we were unable to convert to alternate systems in an efficient and timely manner.

Our business is dependent on continued good relations with our vendors. In particular, we believe that we generally are able to obtain attractive pricing and other terms from vendors because we are perceived as a desirable customer. Our failure to maintain good relations with our vendors could increase our exposure to shifts in market demand, which may in turn lead to improper inventory levels and increased inventory markdown rates.

Substantially all of our assets are encumbered by bank debt. At February 3, 2001, the amount of bank debt outstanding was $361.8 million. As of March 30, 2001, we were in compliance with all of the covenants contained in our credit agreement. However, if we fail to comply with all of the covenants contained in the credit agreement (including a fixed charge coverage ratio if our borrowing availability falls below a certain specified level) or otherwise default on our secured debt, the lender could foreclose against our assets and effectively force a termination of our business. In addition, our leveraged position impairs our ability to obtain additional financing to fund working capital requirements, capital expenditures or other purposes.

The amount of our credit facility for cash borrowings and letters of credit needed for the purchase of new inventory is based on specified percentages of our inventory on hand as well as in-transit inventory from overseas, certain receivables and certain of our owned real estate. Our borrowing availability under the existing credit facility fluctuates relative to this borrowing base. This borrowing base varies in value as a result of sales, merchandise purchases, and profitability. Lack of short-term liquidity due to reaching the limits of our borrowing availability would adversely affect our business, results of operations, and financial condition.

We incurred net losses of $240.6 million in our fiscal year ended February 3, 2001 and, to date, consistent with normal seasonal patterns as discussed above, we have continued to incur net losses in the first quarter in our current fiscal year. There can be no assurance that losses will not continue in the future. If losses do continue to occur, we will likely need to obtain additional capital to continue our operations.

All subsequent written and oral forward-looking statements attributable to us or persons acting on our behalf are expressly qualified in their entirety by these factors and the cautionary statements contained herein.

Disclosure About Market Risk

We have exposure to interest rate volatility primarily relating to interest rate changes applicable to revolving loans under our credit facility. These loans bear interest at rates which vary with changes in (i) the London Interbank Offered Rate (LIBOR) or (ii) the Index Rate (as defined in our credit agreement).

We do not speculate on the future direction of interest rates. As of the end of fiscal years 2000 and 1999 our exposure to changing market rates was as follows:

	February 3, 2001	January 29, 2000
Variable rate long-term debt ($US)	**$361.8 million**	$174.5 million
Average interest rate	**8.54%**	8.31%

A one percent increase in the average interest rate would have resulted in an additional $4.4 million in interest expense during Fiscal 2000.

Report of Independent Public Accountants

To the Stockholders and Board of Directors of
Ames Department Stores, Inc.:

We have audited the accompanying consolidated balance sheets of Ames Department Stores, Inc. (a Delaware corporation) and subsidiaries as of February 3, 2001 and January 29, 2000, and the related consolidated statements of operations, changes in stockholders' equity and cash flows for the fifty-three weeks ended February 3, 2001, and the fifty-two weeks ended January 29, 2000 and January 30, 1999. These consolidated financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these consolidated financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of Ames Department Stores, Inc. and subsidiaries as of February 3, 2001 and January 29, 2000, and the results of their operations and their cash flows for the fifty-three weeks ended February 3, 2001, and the fifty-two weeks ended January 29, 2000 and January 30, 1999 in conformity with accounting principles generally accepted in the United States.

Arthur Andersen LLP

New York, New York

March 16, 2001

Consolidated Statements of Operations

(In thousands, except per share amounts)	53 Weeks Ended February 3, 2001	52 Weeks Ended January 29, 2000	52 Weeks Ended January 30, 1999
Net sales	**$3,953,585**	$3,836,854	$2,498,648
Leased department and other income	**46,413**	41,690	30,164
Total revenue	**3,999,998**	3,878,544	2,528,812
Costs and expenses:			
Cost of merchandise sold	**2,932,251**	2,715,386	1,777,661
Selling, general, and administrative expenses	**1,058,668**	1,068,175	660,593
Depreciation and amortization expense, net	**79,689**	65,495	14,478
Interest and debt expense, net	**87,961**	60,843	15,253
Store closing charge	**129,806**	—	8,222
(Loss) income before income taxes	**(288,377)**	(31,355)	52,605
Income tax benefit (provision)	**54,753**	49,589	(18,775)
Income before Cumulative Effect of Accounting Change	**(233,624)**	18,234	33,830
Cumulative Effect of Accounting Change, net of tax of $614	**—**	(1,107)	—
(Loss) income before extraordinary item	**(233,624)**	17,127	33,830
Extraordinary loss on early extinguishment of debt, net of tax	**(6,964)**	—	—
Net (loss) income	**$ (240,588)**	$ 17,127	$ 33,830
Basic net (loss) income per common share:			
Before Cumulative Effect of Accounting Change and Extraordinary item	**$ (7.95)**	$ 0.66	$ 1.47
Cumulative Effect of Accounting Change, net of tax	**—**	(0.04)	—
Extraordinary item, net of tax	**(0.24)**	—	—
Net (loss) income	**$ (8.19)**	$ 0.62	$ 1.47
Weighted average common shares	**29,383**	27,517	23,010
Diluted net income per common share:			
Before Cumulative Effect of Accounting Change and Extraordinary item	**$ (7.95)**	$ 0.66	$ 1.40
Cumulative Effect of Accounting Change, net of tax	**—**	(0.04)	—
Extraordinary item, net of tax	**(0.24)**	—	—
Net (loss) income	**$ (8.19)***	$ 0.62	$ 1.40
Weighted average common and common equivalent shares	**29,543**	27,658	24,216

* Common equivalent shares have not been included because the effect would be anti-dilutive.

(The accompanying notes are an integral part of these consolidated financial statements.)

Consolidated Balance Sheets

(In thousands, except share and per share amounts)	**February 3, 2001**	January 29, 2000
Assets		
Current Assets:		
Cash and cash equivalents	**$ 49,761**	$ 30,612
Receivables:		
Trade	**6,978**	7,426
Other	**10,061**	17,876
Total receivables	**17,039**	25,302
Merchandise inventories	**744,132**	831,387
Prepaid expenses and other current assets	**41,494**	36,772
Deferred taxes, net	**17,771**	28,854
Total current assets	**870,197**	952,927
Fixed Assets:		
Land and buildings	**32,179**	25,388
Property under capital leases	**180,585**	176,107
Fixtures and equipment	**389,986**	310,750
Leasehold improvements	**159,153**	117,734
	761,903	629,979
Less - Accumulated depreciation and amortization	**(213,904)**	(128,229)
Net fixed assets	**547,999**	501,750
Other assets and deferred charges	**56,490**	57,256
Deferred taxes, net	**411,891**	346,055
Beneficial lease rights, net	**50,675**	56,280
Goodwill, net	**58,475**	61,026
Total Assets	**$1,995,727**	$1,975,294
Liabilities and Stockholders' Equity		
Current Liabilities:		
Accounts payable:		
Trade	**$ 345,915**	$ 325,356
Other	**78,371**	96,224
Total accounts payable	**424,286**	421,580
Current portion of capital lease and financing obligations	**19,018**	22,086
Self-insurance reserves	**29,878**	29,827
Accrued compensation	**39,366**	42,095
Accrued expenses	**74,839**	91,015
Store closing reserves	**179,365**	55,468
Total current liabilities	**766,752**	662,071
Long-term debt	**606,057**	421,769
Capital lease and financing obligations	**165,365**	180,404
Other long-term liabilities	**49,256**	57,916
Excess of revalued net assets over equity under fresh-start reporting	**11,715**	17,868
Commitments and contingencies		
Stockholders' Equity:		
Preferred stock (3,000,000 shares authorized; no shares issued or outstanding at February 3, 2001 and January 29, 2000, par value per share $.01)	**—**	—
Common stock (40,000,000 shares authorized; 29,473,552 and 29,233,650 shares outstanding at February 3, 2001 and January 29, 2000, respectively; par value per share $.01)	**295**	293
Additional paid-in capital	**532,654**	530,744
(Accumulated deficit) Retained earnings	**(135,445)**	105,143
Treasury stock (80,495 and 79,495 shares at February 3, 2001 and January 29, 2000, respectively, at cost)	**(922)**	(914)
Total Stockholders' Equity	**396,582**	635,266
Total Liabilities and Stockholders' Equity	**$1,995,727**	$1,975,294

(The accompanying notes are an integral part of these consolidated financial statements.)

Consolidated Statements of Changes in Stockholders' Equity

(In thousands)	Preferred Stock Shares	Preferred Stock Amount	Common Stock Shares	Common Stock Amount	Additional Paid-In Capital	Retained Earnings (Accum. Deficit)	Treasury Stock Shares	Treasury Stock Amount	Total Equity
Balance, January 31, 1998	—	—	22,506	$225	$118,971	$ 54,186	—	—	$173,382
Exercise of warrants			824	8	1,387				1,395
Exercise of stock options, net			331	3	1,106				1,109
Issuance of common stock pursuant to executive employment agreement			70	1	1,640				1,641
Issuance of restricted common stock, net			190	2					2
Vesting of restricted common stock					788				788
Recognition of tax attributes					112,775				112,775
Acquisition of treasury shares							(79)	$(914)	(914)
Net income						33,830			33,830
Balance, January 30, 1999	—	—	23,921	$239	$236,667	$ 88,016	(79)	$(914)	$324,008
Exercise of stock options, net			170	2	1,073				1,075
Issuance of common stock pursuant to the equity offering			5,100	51	187,211				187,262
Issuance of restricted common stock, net			30	1					1
Issuance of common stock to Board of Directors			12		367				367
Recognition of tax attributes					105,426				105,426
Net income						17,127			17,127
Balance, January 29, 2000	—	—	29,233	$293	$530,744	$ 105,143	(79)	$(914)	$635,266
Exercise of warrants			100	1	591				592
Exercise of stock options, net			145	1	550				551
Forfeiture of restricted common stock, net			(5)						
Acquisition of treasury shares							(1)	(8)	(8)
Stock option compensation					774				774
Other					(5)				(5)
Net loss						(240,588)			(240,588)
Balance, February 3, 2001	**—**	**—**	**29,473**	**$295**	**$532,654**	**$(135,445)**	**(80)**	**$(922)**	**$396,582**

(The accompanying notes are an integral part of these consolidated financial statements.)

Consolidated Statements of Cash Flows

(In thousands)	**53 Weeks Ended February 3, 2001**	52 Weeks Ended January 29, 2000	52 Weeks Ended January 30, 1999
Cash flows from operating activities:			
Net (loss) income	**$(240,588)**	$17,127	$33,830
Cumulative Effect of Accounting Change	**—**	1,107	—
Net (loss) income before cumulative effect adjustment	**(240,588)**	18,234	33,830
Expenses not requiring the outlay of cash:			
Income tax (benefit) provision	**(54,753)**	(49,589)	18,275
Extraordinary loss on early extinguishment of debt, net of tax	**6,964**	—	—
Depreciation and amortization of fixed and other assets	**87,739**	65,495	15,487
Amortization of debt discounts and deferred financing costs	**4,788**	4,880	2,787
Other, net	**344**	(1,841)	(3,514)
Cash (used for) provided by operations before changes in working capital and store closing activities	**(195,506)**	37,179	66,865
Changes in working capital:			
Decrease (increase) in receivables	**8,263**	4,942	(6,787)
Decrease (increase) in merchandise inventories	**87,255**	(181,546)	12,259
Increase in prepaid expenses and other current assets	**(4,722)**	(20,697)	(2,962)
Increase in accounts payable	**2,706**	20,823	12,233
(Decrease) increase in accrued expenses and other current liabilities	**(26,886)**	(91,467)	24,302
Changes due to store closing activities:			
Payments of store closing costs	**(5,909)**	(9,470)	(2,547)
Store closing charge	**129,806**	—	8,222
Net cash (used for) provided by operating activities	**(4,993)**	(240,236)	111,585
Cash flows from investing activities:			
Acquisition costs, net of cash acquired	**—**	—	(103,857)
Purchases of fixed assets	**(127,075)**	(209,606)	(51,602)
Purchases of leases	**(7,054)**	(38,835)	—
Net cash used for investing activities	**(134,129)**	(248,441)	(155,459)
Cash flows from financing activities:			
Borrowings under the revolving credit facilities, net	**187,251**	129,609	44,935
Payments on debt and capital lease obligations	**(22,668)**	(22,191)	(16,262)
Repurchase of Hills senior notes	**(2,852)**	(4,636)	—
Proceeds from the issuance of senior notes	**—**	200,000	—
Proceeds from the issuance of common stock, net	**—**	187,262	—
Payments of deferred financing costs	**(4,595)**	(7,939)	(10,902)
Proceeds from the exercise of options and warrants	**1,143**	1,440	4,933
Purchase of treasury stock	**(8)**	—	(914)
Net cash provided by financing activities	**158,271**	483,545	21,790
Increase (decrease) in cash and cash equivalents	**19,149**	(5,132)	(22,084)
Cash and cash equivalents, beginning of period	**30,612**	35,744	57,828
Cash and cash equivalents, end of period	**$ 49,761**	$30,612	$35,744

(The accompanying notes are an integral part of these consolidated financial statements.)

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1. Summary of Significant Accounting Policies

(a) Nature of operations

Ames Department Stores, Inc. (a Delaware corporation) and its subsidiaries (collectively, "Ames" or the "Company") are retail merchandisers operating under one business segment. As of March 31, 2001, Ames operated 452 discount department stores in nineteen states in the Northeast, Midwest, and Mid-Atlantic regions, as well as the District of Columbia.

(b) Basis of presentation and principles of consolidation

The preparation of financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosures of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

The consolidated financial statements include the accounts of Ames and its subsidiaries, all of which are wholly-owned. All intercompany accounts and transactions have been eliminated.

Certain prior year items have been reclassified to conform to the current year presentation.

(c) Fiscal year

The Company's fiscal year ends on the Saturday nearest to January 31st. The fiscal year ended February 3, 2001 ("Fiscal 2000" or "2000") included fifty-three weeks. The fiscal years ended January 29, 2000 ("Fiscal 1999" or "1999") and January 30, 1999 ("Fiscal 1998" or "1998") included fifty-two weeks.

(d) Cash and cash equivalents

Ames considers all highly liquid investments with an original maturity of three months or less when purchased to be cash and cash equivalents. As of February 3, 2001 and January 29, 2000, there were no such short-term investments.

(e) Inventory valuation

Inventories are valued at the lower of cost, using the first-in, first-out (FIFO) method, or market and include the capitalization of transportation and distribution center costs.

(f) Internal use software

The Company adopted Statement of Position ("SOP") 98-1 "Accounting for the Costs of Computer Software Developed or Obtained for Internal Use" effective the beginning of Fiscal 1999. Prior to Fiscal 1999, the Company expensed the costs of developing or obtaining internal use software as incurred. The amount of internal use software cost capitalized in 1999 and 2000 was approximately $1.6 million and $2.4 million, respectively.

(g) Fixed assets

Land and buildings, fixtures and equipment, and leasehold improvements are recorded at cost. Major replacements and betterments are capitalized. Maintenance and repairs are charged to earnings as incurred. The cost of assets sold or retired and the related amounts of accumulated depreciation are eliminated from the accounts in the year of disposal, with the resulting gain or loss included in earnings.

(h) Intangible assets

Beneficial lease rights represent the excess of fair market value over contract value of certain of the leases acquired in the acquisition of Hills (see Note 2 for further explanation). Goodwill represents the excess of cost over the fair value of net tangible assets acquired at the date of acquisition. As of February 3, 2001, accumulated amortization of goodwill and accumulated amortization of beneficial lease rights were $11.6 million and $8.2 million, respectively.

The recoverability of the carrying values of intangible assets is evaluated periodically based on a review of forecasted operating cash flows and the profitability of the related business. There were no material adjustments to the carrying values of intangible assets resulting from these evaluations in Fiscal 1999 and 1998. During Fiscal 2000, beneficial lease rights totaling $9.6 million and $2.8 million were written off due to the closing of thirty-two stores and the write-off of impaired assets, respectively, under Statement of Financial Accounting Standards ("SFAS") No. 121.

(i) Depreciation and amortization

Buildings and fixtures and equipment are recorded at cost and are depreciated on a straight-line basis over their estimated useful lives. Buildings are depreciated over 31.5 years, furniture and fixtures over ten years, equipment over seven years, motor vehicles over five years, and computer software and hardware over three to five years. Property under capital leases and leasehold improvements are depreciated over the shorter of their estimated useful lives or their related lease terms. The Company currently has buildings with an aggregate net book value of $117.4 million and $111.4 million and point-of-sale equipment with a net book value of $35.3 million and $25.8 million under capital leases for Fiscal 1999 and 2000, respectively.

Beneficial lease rights are being amortized over the terms of the related leases (which average approximately twenty-five years). Goodwill is being amortized over a twenty-five year period.

The excess of revalued net assets over equity under fresh-start reporting is being amortized over a ten-year period. The amount recorded as a credit to depreciation and amortization was $6.2 million in each of Fiscal 2000, 1999, and 1998.

The unfavorable lease liability is being amortized on a straight-line basis over the applicable lease terms (see Note 5).

Depreciation and amortization includes adjustments recorded pursuant to the application of Statement of Financial Accounting Standards No. 121 "Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to be Disposed Of." The Company did not record an impairment loss during Fiscal 1999 and 1998, but recorded an impairment charge of $5.0 million for Fiscal 2000.

(j) Deferred charges

Debt transaction costs and related issue expenses are deferred and amortized over the term of the associated debt. Lease acquisition and related costs are deferred and amortized over the term of the lease.

(k) Income taxes

Ames files a consolidated federal income tax return. Recorded deferred income taxes are provided for at currently effected statutory rates on the differences in the basis of assets and liabilities for tax and financial reporting purposes. If recorded, deferred income taxes are classified in the balance sheet as current or non-current based upon the expected future period in which such deferred income taxes are anticipated to reverse.

(l) Self-insurance reserves

The Company is self-insured for workers compensation, general liability, property and casualty, and accident and health insurance claims, subject to certain limitations. The Company has insurance coverage for losses that may occur above certain levels. As of February 3, 2001 and January 29, 2000, Ames had established self-insurance reserves of $60.5 million and $66.8 million, respectively. The long-term portion of these reserves is classified as part of other long-term liabilities in the Consolidated Balance Sheets. These reserves are subject to changes in estimates as claims are settled or continue to remain outstanding.

(m) Leased department and other income

Ames has an agreement with an independent contractor that allows the independent contractor to operate shoe departments within the Ames stores. Ames receives a percentage of the sales under the agreement.

(n) Revenue recognition

The Company recognizes revenue when its customer takes possession of merchandise. An appropriate return for estimated sales returns is recorded and is reflected in accrued expenses in the accompanying Consolidated Balance Sheets.

The Company adopted Staff Accounting Bulletin ("SAB") No. 101 during the fourth quarter of Fiscal 1999, effective as of the beginning of Fiscal 1999. Prior to the adoption of SAB No. 101, the Company recorded layaway sales when customers placed merchandise on layaway. SAB No. 101 mandates that layaway sales be recorded when the customer takes possession of the merchandise. The impact of adopting this SAB resulted in a cumulative effect adjustment to 1999 earnings for approximately $1.1 million, net of $0.6 million tax benefit.

(o) Advertising expense

The Company participates in cooperative advertising programs supported by its vendors. Advertising costs are expensed as incurred and are presented net of any funds received from vendors for these programs. The Company expensed $136.6 million, $123.9 million, and $79.7 million for Fiscal 2000, 1999, and 1998, respectively.

(p) New Accounting Pronouncements

In June 1998, SFAS No. 133 "Accounting for Derivative instruments and Hedging Activities" was issued. In June 2000, SFAS No. 138 "Accounting for Certain Derivative Instruments and Certain Hedging Activities," an amendment of SFAS No. 133, was issued. These statements establish accounting and reporting standards requiring that every derivative instrument (including certain derivative instruments embedded in other contracts) be recorded in the balance sheet as either an asset or liability measured at its fair value. The statements also require that changes in a derivative's fair value be recognized currently in earnings unless specific hedge accounting criteria are met. The statements are effective, prospectively, for all fiscal quarters of all fiscal years beginning after June 15, 2000. The Company adopted SFAS No. 133, as amended by SFAS No. 138, effective the beginning of Fiscal 2001. The impact of adopting this standard was not significant.

2. Acquisition and Agency Agreement

Acquisition of Hills Stores Company

On December 31, 1998, HSC Acquisition Corp. ("HSC"), a wholly-owned subsidiary of the Company at the time, acquired in excess of 80% of the outstanding voting stock of Hills Stores Company ("Hills") and approximately 74% of the outstanding Hills 12.5% senior notes. In April 1999, Hills was merged with and into Ames Department Stores, Inc. Total cash consideration for the acquisition of Hills was approximately $129 million.

The acquisition was recorded under the purchase method of accounting and, accordingly, the results of operations of Hills since the acquisition date are included in the accompanying consolidated financial statements. The aggregate purchase price of $129 million was allocated to assets acquired and liabilities assumed based on a determination of respective fair market values at the date of acquisition. The fair value of tangible assets acquired and liabilities assumed were $568 million each. The balance of the purchase price, $129 million, was recorded as two components: an excess of cost over net assets acquired (goodwill) of $70 million, and beneficial lease rights of $59 million.

At the time of the acquisition, Hills operated 155 discount department stores. During 1999, the Company remodeled and converted 151 of the Hills stores to Ames stores. The four remaining Hills stores along with seven other Ames stores were closed. The remodeling and conversion process was completed in September 1999.

Agency Agreement Overview

Concurrent with the Hills acquisition, the Company entered into a transition and agency agreement (the "Agency Agreement") with Gordon Brothers Retail Partners, LLC and The Nassi Group, LLC, (collectively, the "Agent"), which provided that the Agent shall serve for a period of time to operate all of the acquired Hills stores and to conduct inventory liquidation sales at each of those stores prior to its scheduled remodeling or final closure.

The Agency Agreement entitled the Company to receive out of the sale proceeds a minimum amount equal to 40% of the initial retail value or ticketed selling price of the merchandise (the “Guaranteed Return”). The Company was also entitled to an additional payment if the proceeds of the sale exceeded a target percentage of the initial retail value. Finally, the Agency Agreement entitled the Company to reimbursement of certain store operating expenses (e.g., payroll, rent, advertising, etc.) out of the sale proceeds during the agency period.

The Agent was paid a fee (the “Agency Fee”) for its services pursuant to the Agency Agreement. The Agency Fee was an amount equal to the proceeds from the sales of Hills merchandise less a deduction for the reimbursement of store operating expenses, the Guaranteed Return and an allocation to the Company based on sale proceeds in excess of specified levels. The Agency Fee recorded during Fiscal 1999 and 1998 was $41.7 million and $21.7 million, respectively.

The inventory liquidation sales at the Hills stores were completed during the quarter ended July 31, 1999. Proceeds from the sales during the entire agency period exceeded the target percentage referenced above. The Company shared in the excess and thereby realized in excess of the Guaranteed Return for the acquired Hills inventory.

Acquisition of Caldor Sites

During the first quarter of 1999, the Company purchased nine Caldor stores and a former Caldor distribution center for a total cash purchase price of $42.8 million. The Company assumed Caldor’s leases for the nine stores and the distribution center and acquired all of the store fixtures in eight of the stores and all racking, sorting systems, and materials handling equipment in the distribution center.

A component of the $42.8 million purchase price was recorded as fixtures and equipment in the distribution center. The balance of the purchase price was recorded under other assets and deferred charges, and is being amortized over the remaining term of the leases.

Acquisition of Goldblatt’s Department Store Leases

In April 2000, the Company consummated its purchase of the leases for seven stores from Goldblatt’s Department stores, Inc. for a cash purchase price of $7.6 million.

3. Supplemental Information

The following table illustrates the separate contribution to the Company’s consolidated results of operations for Fiscal 1999 of (i) the operations of Ames stores during that year, (ii) the operation of the former Hills stores during that year and various other costs and charges discussed below:

	Fiscal 1999				
(In millions, except per share amounts)	Ames	Hills	Other	Layaway Adjustment	Total
Net sales	$3,465.6	$375.6	$ —	$ (4.4)	$3,836.8
Leased department and other income	39.1	2.6	—	—	41.7
Total revenue	3,504.7	378.2	—	(4.4)	3,878.5
Costs and expenses:					
Cost of merchandise sold	2,467.8	251.2	—	(3.6)	2,715.4
Selling, general, and administrative expenses	838.7	153.0	76.5	—	1,068.2
Depreciation and amortization expense, net	49.1	11.1	5.3	—	65.5
Interest and debt expense, net	54.1	4.1	2.6	—	60.8
Income (loss) before income taxes and cumulative effect	95.0	(41.2)	(84.4)	(0.8)	(31.4)
Income tax (provision) benefit	(34.2)	14.8	68.7	0.3	49.6
Income (loss) before Cumulative Effect	60.8	(26.4)	(15.7)	(0.5)	18.2
Cumulative Effect of Accounting Change, net of tax	—	—	—	(1.1)	(1.1)
Net income (loss)	$ 60.8	$ (26.4)	$(15.7)	$ (1.6)	$ 17.1
Diluted net income (loss) per common share	$ 2.20	$ (0.95)	$(0.57)	$(0.06)	$ 0.62
Weighted average common and common equivalent shares	27.7	27.7	27.7	27.7	27.7

The "Ames" column represents (a) the results of the Ames store base, (b) the results of the former Hills stores after their conversion to Ames stores, and (c) certain expenses associated with the acquisition of Hills, including the interest expense on the acquired Hills senior notes and a pro rata share of the amortization of the goodwill recorded in connection with the acquisition.

The "Hills" column represents (a) the results of operations for the Hills stores during the period that these stores were operated pursuant to the Agency Agreement including depreciation and interest expense directly associated with such stores and (b) Hills corporate overhead expenses, principally the Canton, Massachusetts facility. The cost of merchandise for Hills represents the merchandise sold during this liquidation period adjusted for the Guaranteed Return (see Note 2). The selling, general, and administrative expenses for former Hills include the reimbursable store operating expenses of $84.8 million, the Agency Fee of $41.7 million, and other non-reimbursable expenses of $26.5 million. The depreciation and amortization expense for Hills includes the depreciation and amortization of the revalued fixed assets, the amortization of the beneficial lease rights, and the goodwill recorded in the Hills acquisition. The interest expense reflects interest on the debt and capital lease and financing obligations assumed in the Hills acquisition.

The "Other" column represents expenses incurred during the period of remodeling the Hills stores as well as certain other expenses and tax benefits.

The "Layaway Adjustment" column represents the impact of the change in the method of accounting for layaway sales.

The following table illustrates the separate contribution to the Company's consolidated results of operations for Fiscal 1998 of (i) the operations of Ames stores during that year and (ii) the operation of the Hills stores during January 1999 and various other costs and charges discussed below:

	Fiscal 1998			
(In millions, except per share amounts)	Ames	Hills	Other	Total
Net sales	$2,386.5	$112.1	$ —	$2,498.6
Leased department and other income	29.2	1.0	—	30.2
Total revenue	2,415.7	113.1	—	2,528.8
Costs and expenses:				
Cost of merchandise sold	1,711.3	66.3	—	1,777.6
Selling, general, and administrative expenses	606.9	52.0	1.7	660.6
Depreciation and amortization expense, net	11.3	3.2	—	14.5
Interest and debt expense, net	11.4	2.0	1.9	15.3
Store closing charge	—	—	8.2	8.2
Income (loss) before income taxes	74.8	(10.4)	(11.8)	52.6
Income tax (provision) benefit	(26.7)	3.7	4.2	(18.8)
Net income (loss)	$ 48.1	$ (6.7)	$ (7.6)	$ 33.8
Diluted net income (loss) per common share	$ 1.99	$ (0.27)	$(0.32)	$ 1.40
Weighted average common and common equivalent shares	24.2	24.2	24.2	24.2

In January 1999, the Hills stores were being operated pursuant to the terms and conditions of the Agency Agreement (see Note 2). Approximately one-third of the Hills stores were conducting liquidation sales during January 1999 in order to prepare these stores for their conversion to Ames stores. The cost of merchandise for Hills represents the merchandise sold during January 1999 adjusted for the Guaranteed Return. The selling, general, and administrative expenses for Hills include the reimbursable store operating expenses of $25.4 million, Agency Fee of $21.7 million, and other non-reimbursable expenses of $4.8 million. The depreciation and amortization expense for Hills includes the depreciation and amortization of the revalued fixed assets, the amortization of the beneficial lease rights, and the goodwill recorded in the Hills acquisition. The interest expense reflects interest on the debt, capital lease and financing obligations assumed in the Hills acquisition.

The "Other" column in the foregoing table consists of the cost to exit certain Ames contractual obligations rendered obsolete by the acquisition of Hills, the write-off of the deferred financing costs related to the Company's 1996 credit agreement, the incremental interest expense incurred in January in connection with financing the purchase price of Hills, and the charge recorded in connection with the announced closing of seven Ames stores that closed in 1999.

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4. Long-Term Debt

The Company's outstanding long-term debt as of February 3, 2001 and January 29, 2000 is listed and described below:

(000's omitted)	February 3, 2001	January 29, 2000
Secured Debt:		
Borrowings under the Prior Credit Agreement	**$361,794**	$174,544
Unsecured Debt:		
12.5% Senior Notes, due July 2003, discount rate of 11.79%	**43,605**	46,295
10% Senior Notes, due April 2006	**200,000**	200,000
Total Face Value of Debt	**$605,399**	$420,839
Add: Premium	**658**	930
Amount Due After One Year	**$606,057**	$421,769

The Credit Agreement

In January 2001, the Company signed a commitment letter from General Electric Capital Corporation ("GE Capital") for an $800 million senior secured financing, and subsequently entered into an agreement (the "Credit Agreement") with GE Capital, as agent, and a syndicate of other banks and financial institutions. The Credit Agreement provides for a secured revolving credit facility of up to $750 million, with a sub-limit of $50 million for letters of credit, and a secured term facility for $50 million.

The Credit Agreement replaced the Company's previously existing $650 million credit facility (the "Prior Credit Agreement").

The Credit Agreement expires on March 2, 2004 and is secured by substantially all of the assets of the Company. The interest rate per annum on borrowings under the Credit Agreement is equal to the Index Rate (as defined in the Credit Agreement) plus a specified margin or the LIBOR Rate (as defined in the Credit Agreement) plus a specified margin.

Fees required under the Credit Agreement include (a) monthly commitment fees on the unused portion of the facility, (b) an initial closing fee, and (c) a monthly collateral monitoring fee and an annual administrative fee for the account of the agent.

The maximum amount of borrowing under the Credit Agreement cannot exceed the lesser of (a) the total facility less (i) letters of credit outstanding and (ii) a specified minimum balance (the "Minimum Availability") or (b) an amount derived from combining specified percentages of the Company's inventory on hand as well as in-transit inventory from overseas, certain receivables and certain of the Company's owned real estate (each of which may be offset by certain specified reserves) less (i) letters of credit outstanding and (ii) the Minimum Availability.

In addition, if the Company's incremental borrowing capacity under the Credit Agreement averages below a specified level (the "Fixed Charge Availability") over a five-day period, then the Company must be in compliance with a fixed charge coverage ratio for a specified period of time, after which the Company's borrowing capacity must be above the Fixed Charge Availability. The Credit Agreement also restricts the payment of cash dividends.

The Company believes that the availability under the Credit Agreement, along with its current available cash plus expected cash flows from its operations, will enable the Company to fund its expected needs for working capital, capital expenditures, and debt service requirements. Achievement of expected cash flows from operations and compliance with the Credit Agreement covenants are dependent upon the Company's attainment of its Fiscal 2001 business plan.

For Fiscal 2000 and Fiscal 1999, the weighted average interest rate on the Company's revolving credit facilities was 8.61% and 8.12%, respectively, and the peak borrowing levels for the two years were $611 million and $415 million, respectively. As of February 3, 2001, borrowings under the Prior Credit Agreement were $362 million and $1.2 million and $31.3 million was outstanding in trade and standby letters of credit, respectively.

Senior Notes due 2003

The 12.5% Senior Notes due 2003 (the "Hills Senior Notes") were, at the time of the acquisition of Hills, an unsecured obligation of Hills. The Hills Senior Notes pay interest semiannually in January and July and mature July 2003.

During Fiscal 1999 and 2000, the Company, through open market purchases, acquired Hills Senior Notes having a face value of $4.6 million and $2.7 million, respectively. In addition, during Fiscal 1999, as part of the final valuation of the fair market value of all assets and liabilities acquired in the Hills acquisition, the Company revalued the Hills Senior Notes at a discounted rate of 11.79%. As of February 3, 2001 and January 29, 2000, Hills Senior Notes with a face value of $43.6 million and $46.3 million and a recorded value of $44.3 million and $47.2 million, respectively, remained outstanding.

Senior Notes due 2006

On April 27, 1999, the Company completed the sale of $200 million of its 10% seven-year senior notes (the "Ames Senior Notes"). The net proceeds from the sale of the Ames Senior Notes, approximately $193.4 million, were used to reduce outstanding borrowings under the Prior Credit Agreement.

The Ames Senior Notes pay interest semi-annually in April and October and mature April 2006.

As of February 3, 2001, the payments due on long-term debt for the next five years and thereafter were as follows:

Fiscal Years Ending January (000's omitted)	Amount
2002	$ —
2003	361,794
2004	43,605
2005	—
2006	—
Thereafter	200,000

five

5. Lease Commitments, Beneficial Leases and Unfavorable Lease Liability

Ames is committed under long-term leases for various retail stores, warehouses, and equipment expiring at various dates through 2026 with varying renewal options and escalating rent clauses. Some leases are classified as capital leases under SFAS No. 13. Ames generally pays for real estate taxes, insurance, and specified maintenance costs under real property leases. Most leases also provide for contingent rentals based on percentage of sales in excess of specified amounts.

Future minimum lease payments for leases as of February 3, 2001 were as follows:

	Lease Payments		
Fiscal Years Ending January (000's omitted)	Capital Leases	Financing Obligations	Operating Leases
2002	$ 33,654	$ 6,257	$ 77,308
2003	30,333	4,678	64,301
2004	27,468	5,081	57,675
2005	21,579	12,250	51,021
2006	18,986	—	44,116
Thereafter	145,085	—	277,191
Total minimum lease payments	277,105	28,266	$571,612
Less: amount representing estimated executory costs	1,457	—	
Net minimum lease payments	275,648	28,266	
Less: amount representing interest	113,232	6,299	
Present value of net minimum lease payments	162,416	21,967	
Less: currently payable	14,883	4,135	
Long-term lease obligations	$147,533	$ 17,832	

At February 3, 2001, the financing obligations represent sale/lease-back arrangements. The leases, which have terms up to forty-four months, include options to purchase some or all of the assets either at the end of the initial lease term or renewal periods at an amount not greater than the then current fair market value of the properties.

Total minimum lease payments have not been reduced by minimum sublease rentals to be received in the aggregate under non-cancellable subleases of operating leases of approximately $8.0 million as of February 3, 2001. Amortization of capital lease assets was approximately $19.5, $19.8, and $2.8 million for Fiscal 2000, Fiscal 1999, and Fiscal 1998, respectively. Accumulated amortization of capital lease assets at February 3, 2001 was $45.7 million. Rent expense (income) was as follows:

(000's omitted)	**Fiscal 2000**	Fiscal 1999	Fiscal 1998
Minimum rent on operating leases	**$81,661**	$78,946	$55,566
Contingent rental expense	**9,084**	8,812	7,797
Sublease rental income	**(1,950)**	(1,423)	(1,609)

An unfavorable lease liability was recorded in December 1992 under fresh start reporting and represents the estimated liability related to lease commitments that exceeded market rents for similar locations. As of February 3, 2001 and January 29, 2000, the unfavorable lease liability was $10.0 million and $11.2 million, respectively, and is classified as part of other long-term liabilities in the Consolidated Balance Sheets. This liability is being amortized as a reduction to depreciation and amortization expense in the Consolidating Statements of Operations over the remaining lease terms. The amortization, recorded as a reduction to depreciation and amortization expense, was $1.3 million in Fiscal 2000 and $1.4 million in each of fiscal years 1999 and 1998.

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6. Stockholders' Equity

Common Stock

On May 24, 1999, the Company completed the public offering of 5.1 million shares of Common Stock at a price of $38.75 per share. The proceeds, net of underwriting discounts, of approximately $187.3 million, were used to reduce borrowings under the Prior Credit Agreement and for general corporate purposes.

The Board of Directors of the Company may authorize the issuance of one or more series of Preferred Stock and specify for each such series the voting powers (but not greater than one vote per share), designations, preferences, and relative, participating, optional, redemption, conversion, exchange, or other special rights, qualifications, limitations, or restrictions of such series, and the number of shares in each series.

Holders of shares of Common Stock are entitled to one vote per share on all matters to be voted upon by stockholders and are entitled to receive dividends when, as, and if declared by the Board of Directors. Dividends cannot be declared under the terms of the Credit Agreement.

Treasury Stock

In August 1998, the Company's Board of Directors approved a stock repurchase program and authorized management to purchase up to 1.5 million shares of Common Stock. During Fiscal 1998, the Company acquired 79,495 shares of its Common Stock. The Company did not repurchase any of its Common Stock during Fiscal 1999. During Fiscal 2000, the Company acquired 1,000 shares of its Common Stock, increasing the total Common Stock held to 80,495 shares.

Warrants

An aggregate of 200,000 Series B Warrants were issued on December 30, 1992. Each such warrant entitled the holder to purchase one share of Common Stock at any time from June 30, 1993 through December 30, 2000. The exercise price was $5.92 per share. During Fiscal 1998, 100,000 Series B Warrants were exercised. No Series B Warrants were exercised during Fiscal 1999. During Fiscal 2000, the remaining, outstanding 100,000 Series B Warrants were exercised.

Stock Purchase Rights Agreement

On November 30, 1994, the Company adopted a Stock Purchase Rights Agreement (the "Rights Agreement"). Unless previously redeemed by the Company, the rights will expire on November 29, 2004.

On September 24, 1999, the Company amended the Rights Agreement (the "Amendment"), which was approved by the Company's Board of Directors. Among other things, the Amendment amends the exercise price of a right issued pursuant to the Rights Agreement to $180.00, subject to adjustment, and makes certain other technical amendments to the Rights Agreement, most notably the elimination of certain provisions commonly known as "continuing director" provisions.

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7. Stock Options

The Company currently has in place four stock option plans that, in general, permit the Company to grant to employees and non-employee directors options to purchase the Company's Common Stock at an exercise price not less than 100% of the fair market value of the Common Stock on the date of grant. These options, depending upon the plan under which they were granted, are exercisable from six months to five years after date of grant and generally terminate ten years after date of grant.

The following table sets forth the stock option activity for all stock option plans for Fiscal 2000, Fiscal 1999 and Fiscal 1998 (shares in thousands):

	2000		1999		1998	
	Number of Shares	**Weighted Average Exercise Price**	Number of Shares	Weighted Average Exercise Price	Number of Shares	Weighted Average Exercise Price
Outstanding at beginning of year	**1,618**	**$22.88**	1,128	$12.00	914	$ 3.97
Granted	**1,202**	**7.84**	744	35.51	608	19.09
Exercised	**(145)**	**3.78**	(173)	6.48	(375)	3.90
Forfeited	**(135)**	**18.20**	(81)	21.46	(19)	12.42
Outstanding at end of year	**2,540**	**17.11**	1,618	22.88	1,128	12.00
Options exercisable at year-end	**780**	**19.83**	559	10.93	490	5.79
Weighted average fair value of options granted	**$5.95**		$24.90		$13.56	

The fair value of options granted per the above table was estimated on the date of grant using the Black-Scholes pricing model with the following assumptions: no dividend yield, expected option volatilities ranging from 68% to 118%, a risk-free interest rate equal to U.S. Treasury securities with a maturity equal to the expected life of the option (weighted average interest rate of 6.0%, 5.3% and 5.2% for 2000, 1999 and 1998, respectively), and an expected life from date of grant until option expiration date (weighted average expected life of 5.2, 5.3 and 5.4 years for 2000, 1999 and 1998, respectively).

The following table summarizes information about stock options outstanding as of February 3, 2001 (options in thousands):

	Options Outstanding			Options Exercisable	
Range of Exercise Prices	Number Of Options Outstanding at 2/3/01	Weighted Average Remaining Contractual Life	Weighted Average Exercise Price	Weighted Number Exercisable at 2/3/01	Weighted Average Exercise Price
$1.50-3.00	84	4.2	$ 2.49	84	$ 2.49
$3.13-4.59	117	3.4	3.64	108	3.57
$6.06-7.06	228	4.4	6.99	10	6.74
$7.45-8.44	867	4.4	7.47	50	7.70
$14.38-24.75	589	2.9	19.26	254	17.64
$29.00-48.50	655	3.5	35.77	274	36.33
	2,540	3.8	17.11	780	19.83

The Company accounts for its stock option plans under Accounting Principles Board ("APB") Opinion No. 25. Had compensation cost for the Company's 2000, 1999, and 1998 stock option grants been determined in accordance with SFAS No. 123, the Company's net income and net income per common share for Fiscal 2000, Fiscal 1999, and Fiscal 1998 would have approximated the pro forma amounts below:

	Fiscal 2000		Fiscal 1999		Fiscal 1998	
	As Reported	**Pro Forma**	As Reported	Pro Forma	As Reported	Pro Forma
Net income	**$(240,588)**	**$(246,344)**	$17,127	$10,747	$33,830	$32,065
Net income per common share:						
- basic	**$ (8.19)**	**$ (8.38)**	$ 0.62	$ 0.39	$ 1.47	$ 1.39
- diluted	**(a)**	**(a)**	$ 0.62	$ 0.39	$ 1.40	$ 1.32

(a) Common stock equivalents have not been included because the effect would be anti-dilutive.

SFAS 123 does not apply to stock options granted prior to 1995.

8. Income Taxes

The Company adopted SFAS No. 109 "Accounting for Income Taxes" in conjunction with the adoption of fresh-start reporting in December 1992.

As a consequence of the adoption of fresh-start reporting and SFAS No. 109, any tax benefits realized in the prior years for tax purposes after the consummation date for pre-consummation cumulative temporary differences, as well as for the pre-consummation net operating loss carryovers, were reported as additions to paid-in-capital rather than as reductions in the tax provisions in the Consolidated Statements of Operations. Tax benefits or liabilities realized for book purposes after the consummation date were segregated from pre-consummation deferred tax assets. Such tax benefits or liabilities of post-consummation will impact future income tax provisions. Such income tax provisions will have no significant impact on the Company's taxes payable or cash flows.

For Fiscal 2000, the Company recorded an income tax benefit of $54.8 million. Included in that benefit is a provision for state income taxes of approximately $1.1 million, of which $0.3 million will be paid in cash. During this fiscal year, the Company increased its valuation allowance by $64 million, as discussed below.

The (benefit) provision for income taxes is comprised of the following:

(In millions)	**Fiscal 2000**	Fiscal 1999	Fiscal 1998
Federal income tax	**$ —**	$ —	$ 0.5
State income tax	**1.1**	1.2	—
Deferred tax (benefit) provision	**(55.9)**	(12.7)	18.3
Valuation allowance reduction	**—**	(38.1)	—
Total income tax (benefit) provision	**$(54.8)**	$(49.6)	$18.8

Significant components of the Company's deferred tax assets (liabilities) are as follows:

(In millions)	**February 3, 2001**	January 29, 2000
Fixed assets	**$ (2)**	$ 4
Self insurance reserves	**15**	23
Store closing reserves	**75**	22
Leases	**—**	2
Inventory reserves	**2**	1
Vacation pay reserve and other	**45**	37
Net operating loss carryovers	**400**	327
Total deferred tax assets	**535**	416
Valuation allowances	**(105)**	(41)
Net deferred tax assets	**$ 430**	$ 375

The Company's provision for income taxes resulted in effective rates that varied from the statutory federal income tax rate as follows:

	Fiscal 2000	Fiscal 1999	Fiscal 1998
Statutory federal income tax (benefit) rate	**(35.0%)**	(35.0%)	35.0%
State and local taxes, net of federal benefit	**(5.0%)**	(3.7%)	2.9%
Goodwill amortization	**(0.4%)**	2.3%	(3.4%)
Other	**0.7%**	0.4%	1.1%
Effective tax rate before valuation allowance reduction	**(39.7%)**	(36.0%)	35.6%
Valuation allowance (reduction) increase	**21.2%**	(122.1%)	—
Total effective tax (benefit) rate	**(18.5%)**	(158.1%)	35.6%

In assessing the realizability of deferred tax assets, management considers whether it is more likely than not that some or all of the deferred taxes will not be realized. The Company has increased its valuation allowance on its deferred tax assets by $64 million during

Fiscal 2000. The valuation allowance reduced the deferred tax asset to an amount, which the Company believes, more likely than not, that it will realize based on the Company's estimated future earnings. If the Company is unable to generate sufficient taxable income in the future during the loss carryforward periods, increases in the valuation allowance will be required through a charge to the tax expense.

The Company has net operating loss carryovers of approximately $1.0 billion, which are currently available without any annual limitation. The ability to use these losses will expire between 2007 and 2021. Net operating losses and other tax credits will be subject to an annual limitation if the Company experiences a change in control as defined by Internal Revenue Code Section 382. Additionally, the Company has filed a $20 million refund claim under Section 172(f) of the Internal Revenue Code. The Company has received from the IRS an adverse Technical Advice Memorandum ("TAM"). The positions set forth in the TAM would have the effect of denying all or virtually all of the refund claim. The Company is presently considering what further action to take.

In addition, Ames has targeted jobs tax credit carryovers of approximately $7 million, which will expire beginning in 2004, and alternative minimum tax credit carryovers of approximately $4 million, which have no expiration period. Federal net operating loss carryovers for fiscal years subsequent to January 27, 1990 are subject to future adjustments, if any, by the IRS.

As a result of the acquisition of the common stock of Hills, Ames had succeeded to the tax attributes of Hills, including net operating losses of $241 million and general business credits of $11 million. These tax attributes expire between 2001 and 2018. Ames also has succeeded to minimum tax credit carryforwards of $3 million, which do not expire. These tax attributes are significantly limited under Internal Revenue Code Sections 382 and 383, respectively, as a result of the change in control caused by the Hills acquisition. The resulting deferred tax asset has been reduced accordingly. These tax attributes would be further limited if the Company experiences a change in control as defined by Internal Revenue Code Section 382.

Ames has substantial potential state net operating loss carryovers. The utilizable amounts of such state operating losses have not been quantified because of the uncertainty related to the mix of future profits in specific states.

Hills filed a claim for a refund of federal taxes for the subsequent years. The refund claim, which is pending from the IRS, could result in a refund of approximately $7.0 million. If the Company receives this refund amount, there will be a corresponding adjustment to goodwill recorded in connection with the Hills acquisition.

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9. Benefit and Compensation Plans

Retirement and Savings Plans

Ames has defined contribution retirement and savings plans that are qualified under Sections 401(a) and 401(k) of the Internal Revenue Code of 1986, as amended, for employees who are classified as full-time and have at least sixty days of service, or who are part-time and have one year of service, and have completed at least one thousand hours of service in a twelve month period. For each participant's contribution (up to a maximum of 5% of such participant's total compensation), the Company contributes to the Retirement and Savings Plan an amount equal to 50% of the first 4% and 100% of the next 1% contribution. Ames funds all administrative costs incurred by the plans. Ames's expense associated with this plan amounted to approximately $5.2 million, $6.0 million, and $3.6 million, in 2000, 1999, and 1998, respectively.

Annual Incentive Compensation Plan

The Company has an Annual Incentive Compensation Plan (the "Annual Bonus Plan") that is subject to annual review by the Board of Directors. The Annual Bonus Plan provides annual cash bonuses based on the achievement of the Company's financial goals for the year (and customer service goals for store and field management). There are approximately 1,500 members of management eligible under the plan. Bonus expense recorded under the plan was $8.8 million, $9.4 million, and $8.3 million for Fiscal 2000, 1999, and 1998, respectively.

Restricted Stock Awards

1995 Long Term Incentive Plan

Pursuant to the Company's 1995 Long Term Incentive Plan (the "1995 Incentive Plan"), the Company may make awards of an aggregate amount of up to 500,000 shares of Common Stock and cash payment in an amount up to 50% of the fair market value (as defined in the 1995 Incentive Plan) of the Common Stock awarded, determined as of and paid on the vesting date.

As of February 3, 2001, awards aggregating to 355,000 shares of Common Stock had been made to certain executives of the Company, 35,000 of which remain unvested.

1998 Incentive Plan

Pursuant to the Company's 1998 Management Stock Incentive Plan (the "1998 Incentive Plan"), awards aggregating 180,000, 45,000 and 10,000 shares of Common Stock were made to certain executives during Fiscal 1998, 1999, and 2000, respectively. As of February 3, 2001, awards with respect to 205,000 shares of Common Stock, net of forfeitures, remained issued. Fifty percent (50%) of the awards with respect to 195,000 shares of Common Stock vest on the fourth anniversary from the date of grant and 50% on the fifth anniversary. The remaining awards with respect to 10,000 shares of Common Stock vest three years from the date of grant.

A portion of the estimated market value of the awards, including the cash, has been accrued as compensation expense as of February 3, 2001. The Company recorded as compensation expense for the 1995 Incentive Plan and the 1998 Incentive Plan $1.2 million, $1.3 million, and $1.9 million during Fiscal 2000, 1999, and 1998, respectively.

Hills Post Retirement Benefits

In connection with the acquisition of Hills, Ames assumed the obligations for a post retirement medical plan. The plan was subsequently curtailed and the cost associated with the remaining closed group of retirees is not significant.

10. Commitments and Contingencies

Wage and Hour Litigation

Since March 1995, the Company has been named as a defendant in several class action complaints which allege that the Company was obligated to pay overtime to its hardlines and softlines assistant store managers. The Company has consistently stated its belief that these positions are appropriately designated as exempt positions not calling for overtime pay. The Company has settled several of these cases. These settlements have not required any change in the Company's treatment of the status of its hardlines and softlines assistant managers. The Company has entered into a settlement as to one remaining case. This settlement, which is subject to court approval, is described in Item 3 of the Company's annual report on Form 10-K.

Other Matters

In June 1999, the Company announced a $112 million, five-year, strategic outsourcing agreement with IBM to support core information technology systems for the corporate office and the stores. Under the agreement, IBM Global Services is responsible for all data center operations and support for substantially all information systems equipment.

The Company is party to various claims and legal proceedings covering a wide range of matters that arise in the ordinary course of its business. The Company believes that its likely liability as to these matters will not have a material adverse effect on its consolidated financial position or results of operations.

11. Supplemental Cash Flow Information

(000's omitted)	**Fiscal 2000**	Fiscal 1999	Fiscal 1998
Cash paid for interest and income taxes were as follows:			
Interest	**$81,726**	$51,485	$12,166
Income taxes	**$ 1,834**	$ 3,646	$ 125
Ames entered into other non-cash investing and financing activities as follows:			
New capital lease obligations	**$ 4,478**	$14,942	$25,859
Issuance of Common Stock under the 1998 Incentive Plan	**$ —**	$ 1	$ 2

Inventory increased $28.3 million in Fiscal 1999 when a purchase accounting valuation adjustment related to the Hills acquisition was deemed to be no longer necessary and was eliminated, resulting in a corresponding reduction of goodwill. This increase in inventory is properly not reflected as a use of cash in the Consolidated Statement of Cash Flows.

12. Fair Values of Financial Instruments

The Company's financial instruments as of February 3, 2001 and January 29, 2000 were cash, cash equivalents, and long-term debt. For cash and cash equivalents, the carrying amounts reported in the Consolidated Balance Sheets approximated fair values. For long-term debt obligations, the fair values were estimated using a discounted cash flow analysis (based upon the Company's incremental borrowing rates for similar types of borrowing arrangements).

The carrying amounts and fair values of the Company's financial instruments at February 3, 2001 and January 29, 2000 were as follows:

	Fiscal 2000		Fiscal 1999	
(000's omitted)	**Carrying Amount**	**Fair Value**	Carrying Amount	Fair Value
Cash and cash equivalents	**$49,761**	**$49,761**	$30,612	$30,612
Long-term debt:				
Secured debt	**361,794**	**361,794**	174,544	174,544
Unsecured debt	**244,263**	**96,377**	247,225	236,758

13. Store Closing Charges

In the fourth quarter of Fiscal 2000, the Company recorded charges of $139.3 million in connection with the closing of thirty-two stores, including a $9.5 million inventory impairment charge classified as part of cost of merchandise sold. The Company closed the stores during the first quarter of 2001, resulting in a workforce reduction of approximately 2,000 employees.

The Company did not record any charges in connection with the closing of stores in Fiscal 1999. The Company recorded a charge in Fiscal 1998 of $8.2 million for the closing of seven stores.

The following items represent the major components of the total charges recorded in January 2001 and 1999 in connection with store closings:

Item *(000's omitted)*	**Fiscal 2000**	Fiscal 1999	Fiscal 1998
Lease costs	**$ 88,815**	$ —	$ 6,254
Net fixed asset write-down	**29,307**	—	1,161
Other occupancy costs	**9,101**	—	437
Severance costs	**2,583**	—	370
Store closing charge	**129,806**	—	8,222
Inventory write-down	**9,453**	—	—
Total charges	**$139,259**	$ —	$ 8,222

The lease and other occupancy costs provided for in the store closing charge include all projected occupancy costs from date of closing until estimated lease disposition date.

Fixed assets associated with the closing stores were reviewed for impairment in accordance with SFAS No. 121. The review of the closing stores resulted in a write-down of $29.3 million which includes $19.7 million related to fixtures, equipment, and leasehold improvements, and $9.6 million related to beneficial lease rights.

The remaining closed store reserve recorded at the end of Fiscal 1999 primarily reflects the anticipated costs of ongoing property lease commitments for previously announced closed stores and other related facility exit costs.

Management expects to incur substantially all of the charges included in the reserve except lease and other occupancy costs in the first quarter of fiscal year ending February 2, 2002. The lease costs and other occupancy costs are expected to be paid over nine years.

During Fiscal 2000 and 1999, with respect to the thirty-two stores, the Company recorded net sales of $205.0 million and $147.7 million, respectively, exclusive of the period when the thirty-one former Hills stores were operating under the "Hills" name. For the same years, the pre-tax operating loss for the thirty-two stores was $20.4 million and $12.9 million, respectively.

The Company paid approximately $5.9 million, $9.5 million, and $2.5 million in Fiscal 2000, 1999, and 1998, respectively, primarily for lease costs related to previously closed stores.

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14. Leased Department and Other Income

The following is a summary of the major components of "Leased department and other income":

(In thousands) Item	Fiscal 2000	Fiscal 1999	Fiscal 1998
Leased department income	**$27,490**	$25,378	$17,914
Concession and vending income	**2,046**	1,991	1,508
Layaway service fees	**4,193**	3,736	2,644
Gain on sale of assets, net	**3,953**	2,479	1,350
Various other	**8,731**	8,106	6,748
	$46,413	$41,690	$30,164

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15. Quarterly Financial Data (Unaudited)

Summarized, unaudited, quarterly financial data for the last two fiscal years are shown below.

(In thousands, except per share data)	First	Second	Third	Fourth
Fiscal 2000:				
Net sales	**$830,657**	**$872,034**	**$920,321**	**$1,330,573**
Gross margin	**227,733**	**241,153**	**230,559**	**321,889**
Loss before cumulative effect adjustment and extraordinary item	**(29,085)**	**(22,111)**	**(37,236)**	**(145,192)**
Loss per share before cumulative effect adjustment and extraordinary item	**(0.99)**	**(0.75)**	**(1.27)**	**(4.94)**
Net loss	**(29,085)**	**(22,111)**	**(37,236)**	**(152,156)**
Net loss per share - basic	**(0.99)**	**(0.75)**	**(1.27)**	**(5.18)**
- diluted	**(b)**	**(b)**	**(b)**	**(b)**
Fiscal 1999: (a)				
Net sales	$816,159	$859,975	$883,500	$1,277,220
Gross margin	238,586	258,953	245,045	378,884
Income (loss) before cumulative effect adjustment	(28,639)	(21,478)	(27,700)	96,051
Income (loss) per diluted share before cumulative effect adjustment	(1.19)	(0.78)	(0.95)	3.23
Net income (loss)	(29,746)	(21,478)	(27,700)	96,051
Net income (loss) per share - basic	(1.23)	(0.78)	(0.95)	3.30
- diluted	(1.23)	(0.78)	(0.95)	3.23

(a) The first three quarters were restated to reflect the adoption of SAB No. 101 as of the beginning of Fiscal 1999 (see Note 1)

(b) Common stock equivalents have not been included because the effect would be anti-dilutive.

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16. Pro Forma Information (Unaudited)

The following table reflects unaudited pro forma combined results of operations of the Company and Hills on the basis that the Hills acquisition had taken place at the beginning of Fiscal 1998:

(In thousands, except per share amounts)	Year Ended January 30, 1999
Net sales	$4,131,194
Net income (loss)	(54,903)
Earnings (loss) per Common share	$ (2.39)

The unaudited pro forma results were prepared for comparative purposes only. It does not purport to be indicative of the results of operations which actually would have resulted had the acquisition been consummated at the beginning of Fiscal 1998, or of future results of operations of the consolidated entities.

The above pro forma net income and earnings per common share amounts for the year ended January 30, 1999 reflect the previously recorded write-down of Hills deferred tax assets of approximately $49.6 million (which is net of a reversal of approximately $5.9 million of accrued tax liabilities). Excluding the write-down of the Hills deferred tax assets recorded as of October 31, 1998, pro forma net loss and loss per common share would have been $5.3 million and $0.23, respectively, for the year ended January 30, 1999.

Selected Company Data

Market for the Company's Common Stock

Our common stock is traded on the NASDAQ National Market System under the symbol "AMES." The following table provides the high and low sale prices for our common stock as reported on NASDAQ for the fiscal quarterly periods indicated below. These prices do not include retail markups, markdowns or commissions.

	Fiscal 2000		Fiscal 1999	
	Low	**High**	Low	High
1st Quarter	**$13.63**	**$29.38**	$25.38	$38.75
2nd Quarter	**6.25**	**19.06**	34.81	48.88
3rd Quarter	**3.63**	**8.38**	27.63	42.00
4th Quarter	**0.44**	**6.34**	20.75	34.92

On March 30, 2001, there were approximately 6,200 holders of record of the common stock. On that date, the reported closing sale price of our common stock was $2.09.

We paid no quarterly dividends to the holders of our common stock during these periods. Dividends cannot be declared under the terms of our credit facility. Any future determination to pay cash dividends will be at the discretion of the board of directors and will be dependent upon our financial condition, operating results, capital requirements, and such other factors as the board of directors deems relevant.

Selected Financial Data

The following selected financial data of Ames should be read in conjunction with "Management's Discussion and Analysis of Financial Condition and Results of Operations," as well as the consolidated financial statements and related notes appearing elsewhere in this annual report.

(In millions, except per share data)	**Fiscal Year Ended Feb. 3, 2001**	Fiscal Year Ended Jan. 29, 2000	Fiscal Year Ended Jan. 30, 1999	Fiscal Year Ended Jan. 31, 1998	Fiscal Year Ended Jan. 25, 1997
	(b)			(b)	
Net sales (a)	**$3,953.6**	$3,836.9	$2,498.6	$2,225.5	$2,155.3
Net (loss) income	**(240.6)(c)**	17.1(d)	33.8(e)	34.5(f)	17.3(g)
Basic net (loss) income per common share	**(8.19)(c)**	0.62(d)	1.47(e)	1.59(f)	0.85(g)
Diluted net (loss) income per common share	**(8.19)(c)**	0.62(d)	1.40(e)	1.46(f)	0.79(g)(h)
Total assets	**1,995.7**	1,975.3	1,483.4	610.0	536.8
Long-term debt and capital leases	**771.4**	602.2	287.7	35.7	38.2

(a) Net sales for fiscal years ended February 3, 2001 and January 29, 2000 reflect the change in accounting for layaway sales adopted pursuant to SAB 101 (see Note 1 to the consolidated financial statements) and net sales for fiscal years ended January 30, 1999, January 31, 1998, and January 25, 1997 reflect adjustments due to the effect of recording promotional coupons issued by Ames as markdowns, which conforms to the current treatment for coupon accounting.

(b) Fiscal years ended February 3, 2001 and January 31, 1998 consisted of fifty-three weeks; all other years presented consisted of fifty-two weeks.

(c) Includes charges of $139.3 million for the costs associated with the closing of thirty-two stores, including a $9.5 million charge for inventory impairment, and an extraordinary loss, net of tax, of $7.0 million for the early extinguishment of debt.

(d) Includes cumulative effect adjustment for change in accounting for layaway sales of $1.1 million, net of $0.6 million tax benefit, and the recognition of approximately $38 million in tax benefits.

(e) Includes charges of $8.2 million for the costs associated with the closing of seven stores.

(f) Includes charges of $1.6 million for the costs associated with the closing of two stores.

(g) Includes charges of $9.7 million for the costs associated with the closing of thirteen stores and an extraordinary loss, net of tax, of $1.4 million for the early extinguishment of debt.

(h) Net (loss) income per common share has been restated to conform to the requirements of Statement of Financial Accounting Standards No. 128 "Earnings per Share."

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